

Internal Revenue Service
memorandum

CC:TL-N-3114-90
Br4:WHBaumer

date: MAR 27 1990

to: District Counsel, Cincinnati
Attn: Terry Serena

from: Assistant Chief Counsel (Tax Litigation)

subject: Request for Tax Litigation Advice

Docket No. [REDACTED]

This is in reply to your request for tax litigation advice concerning the issue below. We coordinated our response with the Office of the Assistant Chief Counsel (Passthroughs and Special Industries) and that office agreed with the conclusion expressed in our memorandum.

ISSUE

Whether the subject brokerage agreement constitutes a "qualified fixed contract" under I.R.C. § 631(c)(1), and § 178 of Pub. L. No. 98-369, such that the above-referenced taxpayer is entitled to capital gains treatment on the income received under the agreement.

CONCLUSION

The subject brokerage agreement constitutes a "qualified fixed contract" because the agreement is a contract for the sale of [REDACTED] entered into before [REDACTED], and because the other requirements of § 178 of Pub. L. No. 98-369 (relating to binding effect and ability to adjust) are satisfied.

FACTS

The taxpayer, [REDACTED], leases [REDACTED] to his controlled corporation, [REDACTED] (hereafter [REDACTED]), for \$[REDACTED] per ton. On [REDACTED], [REDACTED] entered into a sales agency agreement with [REDACTED] (hereafter [REDACTED]). The agreement designates [REDACTED] as the exclusive sales agent of [REDACTED]. [REDACTED] is obligated to promote the sale and distribution of [REDACTED]'s [REDACTED] in normal markets at the best price attainable. The agreement also provides as follows:

[REDACTED] commits to [REDACTED] and shall produce and furnish throughout the term of this agreement and [REDACTED] shall market in accordance herewith [REDACTED] production equal in amount and quality to one-half of the shipping requirements of any

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contract for the sale and purchase of [REDACTED] at any time during the term hereof existing between [REDACTED] and [REDACTED] for its [REDACTED]

[REDACTED] is to receive a commission equal to [REDACTED] percent of the gross proceeds of all [REDACTED] it sells for [REDACTED]. The agreement is to remain in effect until the termination of the agreement between [REDACTED] and [REDACTED], unless the parties agree to terminate it at an earlier date or extend it beyond the termination of the [REDACTED] contract. Either party would be excused from performance should it be unable to perform at any time by reason of causes or factors beyond its control.

In [REDACTED] of [REDACTED] [REDACTED] and [REDACTED] entered into a comprehensive agreement which established, among other things, both the quantity and the price of the [REDACTED] to be supplied. Both the amount and the price of the [REDACTED] are established in a manner that requires reference to outside information, such as the varying needs of [REDACTED] and price variables for labor, equipment and other capital.

DISCUSSION

I.R.C. § 631(c) provides, in general, that when [REDACTED] is sold, it is considered to be property used in the trade or business of the taxpayer, thereby making it eligible for favorable capital gains treatment under I.R.C. § 1231. However, I.R.C. § 631(c)(1) states that this provision does not apply to a person whose relationship to the person disposing of such [REDACTED] would result in the disallowance of losses under I.R.C. § 267 or I.R.C. § 707(b). In the instant case, the taxpayer would be subject to the provisions of I.R.C. § 267.

I.R.C. § 631(c)(1) became effective for [REDACTED] dispositions after 9-30-85. However, § 178(b)(2) of the Tax Reform Act of 1984, Public Law No. 98-369, made an exception to the above rule. This exception applies to any disposition of an interest in [REDACTED] by a taxpayer to a related person if the [REDACTED] is subsequently sold before 1990 by either the taxpayer or the related person, to a person who is not a related person, and such sale was pursuant to a "qualified fixed contract." The term "qualified fixed contract" is defined as any contract for the sale of [REDACTED], which was entered into before [REDACTED] is binding at all times thereafter, and cannot be adjusted to reflect to any extent the increase in federal income liabilities of the person disposing of the [REDACTED] by reason of the tax amendments to I.R.C. § 631(c).

In your memorandum to us, dated January 16, 1990, you indicate that you are presently satisfied that the [REDACTED] agreement between [REDACTED] and [REDACTED] is a binding contract and that the agreement cannot be adjusted to reflect any increase in the relevant tax liabilities of the person disposing of the [REDACTED]. Your uncertainty primarily rests with the issue of whether the agreement constitutes a "contract for the sale of [REDACTED]."

We agree with your conclusion that the [REDACTED] agreement between [REDACTED] and [REDACTED] is a binding contract. The term "binding contract" was recently defined in Notice 90-6, 1990-3 I.R.B. 5. Although the notice deals with transitional rules made by the Revenue Reconciliation Act of 1989, the definition is similar to other transitional rules. See, for example, the transitional rules of I.R.C. § 469(m) in § 501(a) of Pub. L. No. 99-514. Notice 90-6, which serves as an administrative pronouncement, indicates that conditions outside the control of the parties or the right to negotiate insubstantial contractual terms in the future will not alter the binding nature of a contract for federal tax purposes.

The term "contract for sale" is defined in § 2-106(1) of the Uniform Commercial Code (hereafter UCC), contained in chapter 46 of the West Virginia Code, as both a present sale of goods and a contract to sell goods at a future time. The Official Comments under UCC § 2-106 state that the term "a contract for sale" is employed as a general concept throughout Article 2 of the UCC and encompasses both a present sale and a contract to sell. Under the UCC those parties that enter into a contract to sell are bound to the same legal rights and liabilities as those parties that enter into a contract of sale. See [REDACTED], GCM 37440, CC:I-408-73 (March 2, 1978), p. 2.

UCC § 2-105(2) provides that goods which are not both existing and identified are "future" goods. A purported sale of future goods or of any interest therein operates as a contract to sell. In Cone Mills Corp. v. A.G. Estes, Inc., 377 F. Supp. 222 (N.D. Ga. 1974), a cotton grower sought to avoid enforcement of a contract obligating him to sell, alleging that it was invalid because at the time of execution the goods were not in existence and therefore could not be subject to sale. The court held that the UCC abrogated common law in this respect, citing UCC § 2-105(2) as clear contemplation by the legislature that contracts may be made for the delivery of future goods without specific identification.

The UCC has also changed the common law relating to the need for a fixed price and a fixed quantity of goods. Under the UCC a contract is not unenforceable for lack of definiteness of price or amount if the parties specify a practicable method by which the price or amount can be determined. For example, in UCC

§ 2-306(1) a term which measures the quantity by the requirements of the buyer means such actual requirements as may occur in good faith except that no quantity unreasonably disproportionate to any stated estimate may be demanded.

In the instant case, [REDACTED] has covenanted to produce at least one-half of the [REDACTED] supply required by [REDACTED] at its [REDACTED]. This provision would appear to be a term which measures the quantity by reference to the requirements of the buyer within the meaning of UCC § 2-306(1).

Article 2 of the UCC only applies to transactions in goods. It could be argued that the brokerage contract between [REDACTED] and [REDACTED] is a service contract and that the UCC does not apply. UCC § 1-102 states that the Act shall be liberally construed. When faced with the applicability of the UCC to a commercial transaction, the courts have tended to apply the UCC. For example, in Division of the Triple T Serv., Inc. v. Mobil Oil Corp., 304 N.Y.S.2d 191 (Sup. 1969), aff'd 311 N.Y.S.2d 961 (App. 1970), the court observed:

At first blush one might assume that the ... Code does not reach franchise or distributorship agreements ... However, the courts have not been reluctant to enlarge the type of commercial transactions clearly encompassed within the spirit and intent of the statute.

In the present case, we believe that the language in the [REDACTED] agreement committing [REDACTED] to furnish one-half of the [REDACTED] requirements of the [REDACTED] is subject to UCC § 2-306(1) and therefore is enforceable. Accordingly, we conclude that this portion of the agreement is a contract for the sale of [REDACTED] within the meaning of UCC § 2-106(1) and § 178 of Pub. L. No. 98-369.

In making the above determination we do not feel it is necessary to ascertain whether [REDACTED] is the buyer of the [REDACTED] or whether [REDACTED] is the buyer. In either event, there is a contract for the sale of [REDACTED]. While we believe it is unnecessary to resolve whether [REDACTED] is a buyer, it is instructive to examine the criteria for making such a determination.

Under the UCC, it is important to distinguish between agents and buyers because warranties only run between the buyer and seller. UCC § 2-103(a) defines buyer as a person who buys or contracts to buy goods. The mere fact that a person operates under an exclusive sales agreement does not necessarily mean that such person is an agent of the seller as opposed to a buyer. In Louis DeGidio Oil and Gas Burning Sales and Service, Inc. v. Ace


Engineering Co., 225 N.W.2d 217 (S.C. MN 1974), the court found that a seller-buyer as opposed to a principal-agent relationship was created under an agreement where the contractor became the exclusive representative for sales of the manufacturer's units but received no commissions.

The existence of an agency relationship is a question of fact. According to Restatement, Agency 2d, § 1, Comment b "it is the element of continuous subjection to the will of the principal which distinguishes the agent from other fiduciaries." In Jurek v. Thompson, 241 N.W.2d 788 (S.C. MN 1976), the court held that once contracts to purchase corn were formed between a farmer and his buyer, the farmer had no control over any phase of the buyer's operations and consequently the buyer did not act as a mere conduit between the farmer and the elevator company. The court characterized the relationship between the farmer and the buyer as a dual one involving the sale of services (hauling) and the sale of goods.

If you have any questions concerning the above issue, please contact William Baumer at FTS 566-3325.

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